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No. 98-2010

In the Supreme Court of the United States

CHARLES SCHWAB CORPORATION AND INCLUDABLE SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the commission income that petitioner earned by carrying out trades in stocks and other securities for its customers accrued on the date that the trades were executed or on the settlement date when petitioner delivered the securities or sale proceeds to its customers.

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OPINIONS BELOW

The order of the court of appeals, which simply "adopt[s] the reasoning of the Tax Court" (161 F.3d 1231), is not reproduced in the appendix to the petition. The opinion of the Tax Court (Pet. App. 3a-31a) is reported at 107 T.C. 282.

JURISDICTION

The judgment of the court of appeals (Pet. App. 1a-2a) was entered on December 9, 1998. A petition for rehearing was denied on March 17, 1999 (Pet. App. 32a). The petition for a writ of certiorari was filed on June 15,

1999. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

REGULATIONS INVOLVED

1. As in effect during the years at issue, 26 C.F.R. 1.446-1(c) (1989) provided in relevant part:

§ 1.446-1. General rule for methods of accounting.

* * * * *

(c) *Permissible methods*—(1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

* * * * *

(ii) *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. * * *

2. As in effect during the years at issue, 26 C.F.R. 1.451-1(a) (1989) provided as follows:

§ 1.451-1. General rule for taxable year of inclusion.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

STATEMENT

1. Petitioner provides discount brokerage services through its membership in securities exchanges. As a discount broker, petitioner does not offer the services that a full-service brokerage firm provides—such as underwriting, market making and portfolio management. It also does not give investment advice and does not act as a principal in securities transactions (Pet. App. 7a-8a). When petitioner opens a customer account, the customer signs an agreement acknowledging that petitioner does not provide investment advice. The only service provided by petitioner under its customer agreements is the execution of trade orders (*id.* at 18a).

Each of petitioner's customers is required to provide credit information and to maintain an account with funds on deposit. If a customer fails to make payment on an order, petitioner may liquidate the account to collect amounts due on the trade, including the commission (Pet. App. 18a). The commission charged

by petitioner for executing trades for its customers is accounted for under the accrual method of accounting (*id.* at 6a).

2. In a typical transaction, a customer calls petitioner's telephone number and is connected with the first available representative (Pet. App. 8a-9a). After the customer gives the representative the details of the order, the representative transmits the order to the exchange for execution (*id.* at 9a). In a "market" order placed for immediate execution during the hours that the market is open, the representative ordinarily confirms that the trade has been executed while the customer is still on the telephone (*ibid.*). The market price in effect at the time of the trade determines the price paid or received by the customer; this price, in turn, determines the commission earned by petitioner (*ibid.*). The date on which the trade is executed is known as the "trade date" (*id.* at 8a).

Upon execution of a trade order, petitioner generates an automatic written confirmation slip, which is sent to the customer on the next business day. This written confirmation serves as a notification to the customer of the trade and as an invoice. It itemizes the total cost of the trade, including the commission due from the customer to petitioner, and it lists the total "amount due." The confirmation also encloses a remittance stub and a return envelope in which to transmit payment (Pet. App. 19a).

After the trade is executed, petitioner performs a series of administrative functions. These consist of: (i) recording, in which each transaction is assigned a number associated with the data needed to process the transaction; (ii) figuration, in which the net cost of the securities, commission, taxes, and other amounts associated with the trade are calculated (usually in batch

computer processing the night of the date the trade is executed); (iii) confirmation, in which petitioner mails a written description of the trade, specifying the commission, the settlement date, and other details, to the customer (usually on the first business day after the trade date); (iv) comparison, in which petitioner's records of the transaction are reconciled with those of the counter brokerage firm and with the customer's order, to resolve any discrepancies (beginning the first business day after the trade date and continuing up to settlement); and (v) booking, in which the transaction is entered on petitioner's records, including commissions due (Pet. App. 9a-11a).

On the "settlement date" of a purchase of securities, petitioner delivers the securities to the purchaser and collects the purchase price.[1] If the securities are held in "street name" (that is, in the broker's name), delivery of the securities can be made by a simple change in petitioner's records; if not, the stock certificates are endorsed by the seller and delivered to the buyer on the settlement date (Pet. App. 12a). During the period involved in this case, there was no federal rule specifying the time between the trade date and the settlement date. The exchanges, however, generally required transactions to be settled no later than the fifth business day after the trade date (*id.* at 13a).

Petitioner has a policy against allowing a customer to cancel an order placed in accordance with the customer's instructions (Pet. App. 14a, 19a). Petitioner has maintained in litigation with its customers that an executed order may not be canceled (*ibid.*; see *Yadav* v. *Charles Schwab & Co.*, Fed. Sec. L. Rep. (CCH)

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[1] On the settlement date of a sale of securities, petitioner delivers the proceeds, net of commissions, to the customer.

¶ 95,376 (S.D.N.Y. 1990), appeal reinstated, 935 F.2d 540 (2d Cir. 1991)). A customer's trade order may be canceled only if an entire transaction is canceled, such as when a planned initial public offering is canceled. In that case, the trades do not settle and petitioner collects no commission (Pet. App. 15a).

3. During its 1988 tax year, petitioner earned $3,357,576 in net commission income on transactions executed in that year that were settled in 1989 (Pet. App. 15a). Petitioner failed to include this income on its 1988 return. The Internal Revenue Service determined that this commission income should have been reported as accrued income in 1988. A notice of deficiency was issued based upon that determination.

Petitioner sought review of the deficiency determination in Tax Court. Following an extensive trial involving numerous documents and lengthy testimony, the Tax Court sustained the Commissioner's determination. Applying the "all events" test articulated by this Court in *Spring City Foundry Co.* v. *Commissioner*, 292 U.S. 182, 184-185 (1934), and *Schlude* v. *Commissioner*, 372 U.S. 128, 133, 137 (1963), the Tax Court determined that (i) petitioner's right to receive the commission income became fixed on the date the securities trades were executed and (ii) this income therefore accrued to petitioner on that date, rather than on the subsequent date when the trades were settled (Pet. App. 17a, 23a). The court of appeals affirmed in a brief per curiam opinion that "adopt[s] the reasoning of the Tax Court" (161 F.3d 1231 (1998)).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. A corporation such as petitioner is required to use the accrual method of accounting in reporting and determining its federal income tax obligations. 26 U.S.C. 448(a), 451(a). For accrual basis taxpayers, an item of income accrues—and must therefore be reported—in the tax year when (i) all the events occur that fix the right to receive the income and (ii) the amount of the income can be determined with reasonable accuracy. 26 C.F.R. 1.446-1(c)(1)(ii), 1.451-1(a) (1989); *United States* v. *General Dynamics Corp.*, 481 U.S. 239, 242-243 (1987); *Commissioner* v. *Hansen*, 360 U.S. 446, 464 (1959); *Spring City Foundry* v. *Commissioner*, 292 U.S. 182, 184-185 (1934). Petitioner does not dispute that the amounts of the commissions involved in this case were reasonably determinable on the trade date and that the second prong of the accrual test was therefore met on that date. Petitioner disputes only the determination of the Tax Court, in which the court of appeals concurred, that the first prong of this established test was also met in 1988.

a. Under the accrual method, "it is the *right to receive* and not the *actual receipt*" of an item that determines the timing of its inclusion in income. *Schlude* v. *Commissioner*, 372 U.S. 128, 137 (1963) (quoting *Spring City Foundry* v. *Commissioner*, 292 U.S. at 184-185). Accord *Commissioner* v. *Hansen*, 360 U.S. at 464; *Resale Mobile Homes* v. *Commissioner*, 965 F.2d 818, 822 (10th Cir.), cert. denied, 506 U.S. 874 (1992).

Accrual occurs at the time that a liability to pay or a right to receive a certain amount is "firmly established." *United States* v. *General Dynamics Corp.*, 481 U.S. at 243. See also *Schlude* v. *Commissioner*, 372 U.S. at 137. The fact that taxpayers "cannot *presently* compel [a debtor] to pay to them the amounts [due]" is not controlling. *Commissioner* v. *Hansen*, 360 U.S. at 464. Such amounts accrue as income as soon as the taxpayers acquire "a *presently enforceable right to recover*" the amounts. *Ibid.*

For example, in *Commissioner* v. *Hansen*, automobile dealers argued that they were not required to accrue amounts in reserve accounts owed to them by finance companies because the dealers did not have the right to require present payment of those amounts. In rejecting this argument, the Court observed: "[I]t is a normal result of the accrual basis of accounting and reporting that taxes frequently must be paid on accrued funds before receipt of the cash with which to pay them." 360 U.S. at 466-467. Once an accrual-basis taxpayer has earned the right to payment for services rendered, it must report the income as accrued even if it must later carry out mathematical "calculations" or "ministerial acts" to complete its undertakings. *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. 290, 295-296 (1932); *Resale Mobile Homes* v. *Commissioner*, 965 F.2d at 823.

b. The courts below properly applied these established principles to the facts of this case. The courts correctly held that it is the execution of a trade order from a customer—by locating a seller or purchaser for a specific security on terms acceptable to the customer—that fixes petitioner's right to receive its commission on the trade. The sole service for which customers agree to pay a commission to petitioner is the execution of

securities trades. After petitioner executes the order according to the customer's instructions, the order cannot be canceled and the cost of the trade, including the commission, is promptly billed to the customer (Pet. App. 14a, 18a-19a). The administrative services that petitioner thereafter performs in delivering the securities and collecting its commission are ministerial in nature. Since petitioner's *right to receive* its commissions is fixed on the trade date, it is on the trade date that income accrues to petitioner. See, *e.g.*, *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. at 295 (income accrues regardless of necessity of carrying out a "mere administrative procedure to ascertain the amount to be paid"); *Resale Mobile Homes* v. *Commissioner*, 965 F.2d at 823 ("[a]n accrual basis taxpayer must report income in the year the right to such income accrues, despite the necessity for mathematical computations or ministerial acts"); *Dally* v. *Commissioner*, 227 F.2d 724, 726 (9th Cir. 1955), cert. denied, 351 U.S. 908 (1956) (contractor cannot postpone accrual of payments for units delivered in 1942 until 1943 on the basis that the units had not been certified for payment until the later year). The application of these well-established principles to the particular facts of this case does not warrant review by this Court.

2. Petitioner errs in contending (Pet. i, 3, 5-11) that the decision in this case conflicts with the decision of this Court in *United States* v. *General Dynamics Corp.*, 481 U.S. 239 (1987). The issue addressed in *General Dynamics* was whether a company that acted as a self-insurer for its employee medical expenses could accrue and deduct its liability to reimburse covered medical expenses when the employees had failed to file required claims for reimbursement by the close of the year. 481 U.S. at 244. The Court concluded that the last event

that fixed the company's liability to pay the medical claims was the submission of a proper claim by the employee, for the company had no obligation to reimburse the employee in the absence of the filing of the claim. *Ibid.* The Court observed that claim filing was "not a mere technicality" because employees might fail to file proper forms "through oversight, procrastination, confusion over the coverage provided, or fear of disclosure to the employer of the extent or nature of the services received." *Ibid.* In *General Dynamics*, the Court pointed out that, by contrast, the subsequent *processing* of the forms by the employer was merely a "ministerial" act that would not postpone accrual of the expenses on the company's tax return. 481 U.S. at 244 n.4.

The holding of the courts in the present case that petitioner must accrue commission income in the tax year in which the trades are executed is entirely consistent with the Court's application of the "all events" test under the different facts involved in *General Dynamics*. The execution of securities trades by petitioner is the event that fixes its right to commissions. The post-trade activities performed by petitioner are ministerial functions which, under *General Dynamics* and numerous other decisions, provide no basis to defer accrual of the commission income. See 481 U.S. at 244 n.4; *Continental Tie & Lumber Co.* v. *United States*, 286 U.S. at 295; *Resale Mobile Homes* v. *Commissioner*, 965 F.2d at 823. Following completion of a trade, petitioner is required, of course, to deliver to its customer the securities purchased by the customer or the proceeds from securities sold by the customer. The record of this case, however, amply supports the conclusion of the courts below that these events are of a ministerial nature because they do no more than

"effectuate the mechanics of the transfer and are merely in confirmation of the trade executed" (Pet. App. 18a).[2]

This finding, in which both courts below concurred, does not warrant further review. "[T]his Court has frequently noted its reluctance to disturb findings of fact concurred in by the two lower courts." *Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982). See also *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

3. It is well established, for federal income tax purposes, that petitioner's customers must themselves recognize gain or loss from any sale of securities on the trade date. Rev. Rul. 93-84, 1993-2 C.B. 225; S. Rep. No. 313, 99th Cong., 2d Sess. 131 (1986); H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. Pt. 2, at 297 (1986); *Anderson* v. *Commissioner*, 527 F.2d 198, 199 (9th Cir. 1975).[3] Consistent with that general principle, the Commissioner of Internal Revenue has long taken the position that brokerage commissions from securities trades similarly accrue as of the trade date, not the settlement date. Rev. Rul. 74-372, 1974-2 C.B. 147. The

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[2] Petitioner argues (Pet. 11) that the decisions below contradict "plain common sense" because "[t]he 'essence' of a sale, from a customer's perspective, is the receipt in hand of the net cash proceeds" or, in the case of a purchase, "the delivery of the securities purchased." This argument, however, misdescribes the nature of the transaction. Petitioner executes securities sales and purchases solely as a broker or agent. It does not act as a principal (Pet. App. 7a-8a).

[3] Similarly, in insider-trading cases, courts have held that the trade date, rather than the settlement date, determines whether a purchase or sale of stock falls within the six-month short-swing profit period defined by 15 U.S.C. 78p(b). *Winston* v. *Federal Express Corp.*, 853 F.2d 455, 456 (6th Cir. 1988).

decisions below thus merely implement what has been the formal position of the Internal Revenue Service for the past twenty-five years. In this context, it is plainly unwarranted for petitioner to assert that the decision in this case will destabilize and "confuse the Nation's taxpayers" (Pet. 15) in determining the proper accrual of items of income and expenses.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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